protect the exclusivity granted by the parent network. The result would be to make the network richer, but many advertisers, local television stations, and the buying public, would be poorer, because competing advertisers would be denied access altogether to some of the most-watched television. The network-rep rule guards against consolidating this power in one entity.

2. Repeal Would Undercut the Independent Advisory Role of the Reps.

Another area where a network-owned rep firm would encounter unavoidable, and unhealthy, conflicts of interests is in its role of programming advisor to local stations. The independent reps' role -- under-appreciated by the Notice -- of advising local broadcasters on programming and operational decisions would be severely compromised if the stations' rep firms were owned by the network.

The Commission has always encouraged local broadcasters to make programming decisions that serve their communities' interests.[32] As outlined in Section I, independent reps help local broadcasters make programming decisions because they offer advice on both network and non-network programming -- carriage, scheduling, and preemption. The advice of independent reps helps local stations meet their communities' needs. Independent reps also help strengthen local stations by providing, through sale of national spot advertising, substantial revenues to local stations.

[32] *See, e.g.*, 47 C.F.R. § 73.658(e) ("right to reject" rule).

Given that independent reps serve this important programming advisory function, any case for repealing the rule must show how this function would be effectively discharged when the rep firm giving this advice is owned by a network, which (a) always seeks 100% clearance of its programs, (b) soon will sell syndicated programming, and (c) soon will sell programs for the "access" hour.[33] Can one imagine a network-owned rep firm advising the local affiliate to preempt network programming? The net result would be to undercut the ability of local broadcasters to remain independent packagers, schedulers, and, in part, originators of programming designed to suit community needs.

3. Repeal of Both Rules Would Distort Pricing and Supply of National Advertising.

Another area where the networks would face unavoidable conflicts of interest is the pricing and sale of network and national spot advertising. If a network, which wants to sell network advertising, could control the price and supply and quality of national spot advertising, a reasonably interchangeable good, then it is likely that the network would resolve this conflict in a manner contrary to the stations' and the public's interest.

A network-owned rep firm could diminish the quality of the national spot market, and thereby decrease demand. MiCRA finds that the degree of substitutability between network and national spot advertising has been increasing steadily over time.

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[33] The combination of repeal of Fin/Syn and the prime time access rule has the effect of giving the networks a strong financial interest in having affiliates program this time. Their syndicated or off-network programs.

The reason is that independent reps have changed the characteristics and quality of their product to make it easier for advertisers to switch away from network advertising.[34] MiCRA finds that reducing the competition between suppliers of network and national spot advertising would affect not only the price but also the quality, including the range and diversity, of advertising vehicles available to national and regional advertisers.[35]

The network-owned rep firm also could sell less national spot time, thereby increasing stations' dependence on local spot advertising, which does not compete with network advertising. This could be accomplished in either of two ways. One, the network-owned rep firm could charge stations higher commissions, thus reducing the net price the station receives. Or two, the network-owned rep firm could fail to market aggressively national spots, by, for example, neglecting to notify national advertisers immediately if spot prices fall. The networks could then increase the price of network advertising, since competition from national spot advertising would have diminished.

Whether a network would actually take these steps is conjectural, but what cannot be assailed is that repeal of the network-rep rule and the rule prohibiting network control of advertising roles would confront networks with conflicts of interest that would compromise the viability of local affiliates, make them vulnerable to network buy-outs, undercut affiliate programming competition with the networks, and weaken competition between national spot and network advertising. Abuses would be hard to police.

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[34] Economic Analysis at 9.

[35] *See id.*

Certainly the antitrust laws would be ineffective. A number of reasons support this conclusion: (a) the extended time it takes to bring an antitrust action; (b) the cost and difficulty in bringing such an action (including the fact that the party possessing much of the relevant information, the local station, would be subject to conflicting pressures); and (c) the fact that such cases are rarely resolved quickly. Many rep firms would win justification posthumously. The adverse consequences for the broadcast advertising marketplaces and the public interest would be impossible to reverse.

In contrast, the network-rep rule is easy to enforce and prevents conflicts of interest. It mandates structural separation in circumstances where otherwise the conflicts would be too powerful.

C. <u>Repeal of the Network-Rep Rule Would Also Injure the Program Marketplace.</u>

Another consequence the Commission must consider before repealing the rule is the injurious effect repeal would have on the program marketplace. As outlined above, stations "repped" by networks would be persuaded to buy programs produced and/or syndicated by the network. The result would be that programming not provided by the network would have an even tougher time of getting on the air. The Commission has long advocated a role for independent programmers, since they provide an important source of diversity. Indeed, one of the purposes of the right-to-reject rule is to permit an affiliate to provide non-network programming that meets the needs of its community of license.[36]

This effort to promote diversity in programming and protect the ability of stations to select programming that is responsive to public need in their service areas would suffer a severe and possibly fatal blow with repeal of the network-rep rule. Vertically integrated networks would have powerful incentives to make sure their affiliates carry their programs.[37] The network-rep rule represents a structural check against network hegemony in programming.

V. REPEAL OF RULE PROHIBITING NETWORK CONTROL OF STATION ADVERTISING RATES WOULD SERVE NO PUBLIC INTEREST, AND WOULD STIFLE PRICE COMPETITION.

The Commission found early in its history that enabling one competitor to use its dominant position to influence the price charged by another competitor did not serve competition, and did not serve the public. It reached this conclusion first in the context of radio: the Commission found that competition between a network and its affiliates was stifled when the network could force its affiliates to set their national spot advertising rates high, at the same level as network advertising.[38] The Commission

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[36] 47 C.F.R. § 73.658(e).

[37] Because most of the costs of developing programming are fixed and sunk, the marginal cost to integrated networks of using their own programming is very low. The network composes this marginal cost against the price changed for other programs, in determining whether a program is more profitable to have their affiliates or owned-and-operated stations carry. The result is a strong bias in favor of owned programming.

[38] Commission Order No. 37, Docket No. 5060 (May 1941), at 73-75, *modified, Supplemental Report on Chain Broadcasting* (Oct. 1941), *appeal dismissed sub nom. NBC v. United States*, 47 F. Supp. 940 (1942), *aff'd*, 319 U.S. 190 (1943).

later applied the rule to television broadcasting, out of concern that network control of station advertising rates diminished the ability of local stations to compete with networks for national advertising business.[39]

In 1957 and again in 1980 the Commission's staff thoroughly reviewed the justification for the prohibition on network control of station advertising rates, and both times the Commission concluded that elimination of the rule would harm competition between networks and affiliates for broadcast advertising.[40] The 1980 Network Inquiry Report took the analysis one step further, concluding that permitting a network to set both network and national spot advertising rates amounted to price fixing.[41]

MiCRA asserts that because national spot and network advertising are close substitutes, this rule embodies the simple prohibition against horizontal price fixing by the antitrust laws. MiCRA adds that "[j]oint rate making by independent competitors is usually treated as per se illegal because such activity can result in significant harm to competition, whereas banning the activity poses little or no risk that efficiencies or other benefits will be foregone."[42]

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[39] *Rules Governing Television Broadcast Stations*, 11 Fed. Reg. 33, 37 (Jan. 1, 1946); 47 C.F.R. § 73.658(h).

[40] *Barrow Report*; *Network Inquiry Report*.

[41] *Network Inquiry Report* at 492-93.

[42] Economic Analysis at 11.

The current iron curtain between the pricing decisions of networks and affiliates works well and protects advertisers,[43] since today networks have no influence on pricing policies of their affiliates. The conclusion that networks and affiliates offer closely competing products and therefore should not collude on price-setting was true when the Commission last visited this matter in 1980, and, despite the significant changes in the industry in the last 15 years, remains true today.

The research of the economic literature by MiCRA confirms the view that the rule prohibiting network control of station rates serves the public. The seminal study on network power, Misregulating Television: Network Dominance at the FCC, concludes: "The prohibition of network control of affiliates' national spot rates appears to serve directly the goal of increasing competition, without denying networks or affiliates any offsetting efficiency gains."[44]

Perhaps the most telling point to consider here is the flip side of the question posed in the Commission's Notice: Who benefits if the networks can set or influence the price for national spot advertising, the primary competition for national advertising? Is the American public better off? Are local stations better off? Are advertisers better off if such price fixing is permitted? Where is the showing that the public would benefit if the networks could engage in price fixing?

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[43] Fundamentally, the iron curtain would also be breached by elimination of the network-rep rule, given the influential role reps play with respect to stations' national spot rates.

[44] S. Besen, *et al., Misregulating Television: Network Dominance and the FCC* (1984), at 82.

CONCLUSION

Abandonment of the network-rep rule would eliminate a vital economic prop under the independence of the local affiliates because the rule preserves local stations autonomy in programming decisions and provides an economic base to local stations while offering effective competition to network advertising. Its repeal would threaten the survival of small and medium-size stations and sap the vitality of even larger affiliates. There is also no evidence that the public would be served by repeal of the rule prohibiting networks from controlling station rates, and the economic analysis presented here shows that advertisers and the public would be hurt.

Though the broadcast industry has no doubt changed significantly over the past 15 years, those changes do not alter the fundamental and still compelling national interests underpinning these rules. Consequently, for the reasons set forth here and in the Attachment, the Commission should retain these rules in their current form.

Respectfully submitted,

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AN ECONOMIC ANALYSIS OF THE COMPETITIVE EFFECTS OF ELIMINATING THE NETWORK REPRESENTATION RULE

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I. INTRODUCTION

The network Rep Rule ("the Rep Rule") prohibits networks from representing their affiliates in the sale of spot advertising. This paper provides an economic analysis of the likely effects on competition if the Rep Rule is eliminated and one or more networks eventually represent a significant number of their affiliates.

Part II begins with a discussion of the market conditions that are necessary for elimination of the Rep Rule to increase prices for either network or national spot advertising or both. As shown there, even if network and national spot advertising are not such close substitutes as to be in the same product market, elimination of the Rep Rule can result in higher prices to advertisers. Similarly, elimination of the Rep Rule can pose a danger to competition even if either networks have no market power in a network advertising market or if affiliates cannot affect the prices paid for national spot advertising.

Part III of this paper turns to two sets of empirical evidence relevant to predicting the likely effects on advertisers and affiliates from elimination of the Rep Rule. The first consists of econometric studies of the effect of the presence of a network owned-and-operated station ("O&O") in a market and the effect of concentration in local broadcast markets on the price of national spot advertising. While these studies do not directly test the effects of eliminating the Rep Rule, this type of evidence was relied upon by the Network Inquiry Special Staff ("the NISS") in 1980 in making its recommendation that the Rep Rule be eliminated. A re-examination of the evidence on these issues is important because subsequent research modifies or contradicts the findings of the sole study upon which the NISS relied. The second set of empirical evidence available to predict the likely effects from eliminating the Rep Rule consists of the positions taken by the parties affected by the rule. We find that neither the available econometric evidence nor the positions taken by the parties support the proposition that significant efficiencies can be achieved from eliminating the Rep Rule, or the proposition that elimination of the Rep Rule cannot cause significant harm to competition and to advertisers in both the network and national spot advertising markets.

II. THE APPROPRIATE THEORETICAL FRAMEWORK FOR EVALUATING THE NETWORK REP RULE

A. SUBSTITUTABILITY BETWEEN NETWORK AND NATIONAL SPOT ADVERTISING.

Opponents of the Rep Rule might argue that the Rule can safely be eliminated if network and national spot advertising are not very close substitutes or are not in the same antitrust product market. Alternatively, those who oppose the Rep Rule might argue that if there are many substitutes for national spot in addition to network advertising (or many substitutes for network advertising in addition to national spot), then eliminating the Rep Rule could not raise prices. Finally, opponents might argue that the Rep Rule should be eliminated if either the network advertising or the national spot market is effectively competitive. However, none of these statements is correct.

With respect to the question of product substitutability, elimination of the Rep Rule could obviously lead to higher advertising prices if network and spot advertising are sufficiently close substitutes to be in the same product market and networks gain significant control over the pricing of their affiliates' advertising time. Although we have not carried out an independent analysis of substitution among advertising vehicles, virtually all the trade and academic literature (including the NISS economists[1]), plus industry conventional wisdom,[2] indicate that network and national spot advertising are close (if not the closest) substitutes for each other. Therefore, we believe it is highly likely that a merger among all the broadcast networks and their affiliates would create an entity that could profitably raise advertising rates by a significant amount. Using standard antitrust analysis, this would indicate that network plus national spot advertising comprise a product market, although not necessarily the "smallest" possible market.[3]

Even if network and national spot advertising were not sufficiently close substitutes to

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[1] As the economists on the NISS later noted:

> Moreover, the closest substitutes for within-program spots on a particular network are adjacencies on the same network schedule. By determining the prices for network spots as well as their closest substitutes (national spots appearing in network adjacencies) a network could reduce the scope of competition with its affiliates for the patronage of national advertisers and earn greater profits. Understood in this manner, attempts to determine both those prices constitute attempts to engage in horizontal price fixing. Indeed, during the Chain Broadcasting study NBC offered this explanation for adopting these practices in radio networking. [Stanley M. Besen, Thomas G. Krattenmaker, A. Richard Metzger, Jr. and John R. Woodbury, Misregulating Television: Network Dominance and the FCC, The University of Chicago Press, 1984 [hereafter "BKMW (1984)"] at 79-80.

[2] It is our understanding from interviews with independent reps, for example, that it would not be unreasonable to expect that a price increase for national spot advertising on the order of 10% to 20% would induce up to 40% of advertisers to attempt to switch to network advertising. In contrast, a 10% to 20% increase in the price of local spot advertising would result in virtually no advertisers turning to network advertising as their next best alternative.

[3] See the 1992 FTC/DOJ Merger Guidelines.

be in the same "smallest" relevant product market, elimination of the Rep Rule could lead to higher prices if (a) network and national spot advertising are imperfect substitutes, and (b) either

(i) network advertising is a relevant product market in which Rep Rule-constrained networks have a dominant share, or

(ii) national spot advertising is a relevant product market in which Rep Rule-constrained network affiliates have a dominant share in at least some local markets.

If network and spot advertising are in separate relevant product markets, the potential effect of eliminating the Rep Rule would be analyzed using the framework for assessing the effect of a merger between two firms in closely related markets (i.e., a "semihorizontal" merger). Use of a framework ordinarily applied to mergers is appropriate because elimination of the Rep Rule could give one group of competitors (the networks) control over the pricing decisions of a second group of competitors (the affiliates) who compete with the networks.

The standard analysis of mergers between firms in horizontally related markets is by Werden.[4] Werden shows that even if a semihorizontal merger does not promote tacit or explicit collusion in the way that a horizontal merger can, it can alter the extent to which a firm exercises any market power it might have. Thus a network-affiliate merger (or a joint marketing or representation agreement, or price-setting agreement) would be expected to have no effect on either network or national spot prices only if both the network had no ability to

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[4] See G. Werden, "Section 7 of the Clayton Act and the Analysis of "Semihorizontal" Mergers", The Antitrust Bulletin 27-1, Spring 1982, pp.135-160.

affect price in the network advertising market and the local station had no ability to affect the price of national spot advertising in its local market. Elimination of the Rep Rule, therefore, cannot be defended by showing that either the spot market or the network market is perfectly competitive: both must be competitive for elimination to pose no threat.

Paraphrasing Werden (1982) [at 140], in the case where just one of the two merging firms (e.g. a network) has the power to set price in its market (network advertising), if that network acquired a local station producing an imperfect substitute (national spot advertising) the network would act as if its demand curve in the network market had become less elastic, even if the acquired station was in a competitive market.[5] If the network now raises the price of network advertising, some of its customers would attempt to switch their advertising to the local station, and the price paid for spot national advertising in that local market would be driven up.[6]

We can infer that the supply of national spot advertising time is not perfectly elastic because the total time available for network advertising, national spot advertising, and local spot is relatively fixed, while the demand for local advertising is not infinitely elastic.[7]

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[5] As discussed below, while the analysis in Werden (1982) is carried out in terms that would be appropriate if one network were acquiring (or representing) some of its affiliates, the more appropriate framework in evaluating the effects of eliminating the Rule is in terms of two or more of the networks acquiring (or representing) many of their affiliates.

[6] Only if national spot advertising in that local market were in perfectly elastic supply would its price not rise.

Otherwise, the increase in demand that results from the increase in the price of network advertising would cause the price of spot advertising to rise as its consumption rose. However, we can infer that the supply of national spot advertising time is not perfectly elastic because the total time available for network advertising, national spot advertising, and local spot is relatively fixed, while the demand for local advertising is not infinitely elastic.

Because of this cross-market effect on profits, the network's profit-maximizing price of network advertising would be higher after acquiring its affiliate.

In short, Werden's analysis shows that even if an affiliate were a perfect competitor in a market for national spot advertising, a merger could result in higher prices for network advertising if the network has market power.

Alternatively, assume that a network were a perfect competitor in a market for network advertising. A network-affiliate merger, joint marketing or representation agreement, or price fixing agreement could raise network and national spot advertising rates if the quantity or price of national spot advertising provided by the affiliate (or all affiliates combined) could affect the price paid for national spot advertising in local markets. Specifically, if a network controlled prices charged by its affiliates for national spot advertising and the network raised the prices of its affiliates' national spot advertising, some of the affiliates' customers would reduce their purchases of national spot advertising and attempt to replace it with network advertising.[8] The price the networks could charge for network advertising would then rise.[9] Only if network advertising were in perfectly elastic supply would its price not rise.[10]

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[8] As discussed in note 2 supra, the percentage of national spot customers that could be expected to attempt to switch is likely to be quite high.

[9] As discussed below, while the analysis in Werden (1982) is carried out in terms that would be appropriate if one network were acquiring (or representing) some of its affiliates, the more appropriate framework in evaluating the effects of eliminating the Rule is in terms of all the networks acquiring (or representing) their affiliates. This clearly increases the likelihood that network and national spot advertising rates would rise.

[10] See note 6 supra. We can infer that the supply of network advertising time is not perfectly elastic because the total time available for network advertising, national spot advertising, and local spot is relatively fixed, while the demand for local advertising is not infinitely elastic.

Further, if the networks do not act as perfect competitors in the market for network advertising, the price effects become even stronger, although the analysis is more complex.[11]

There are two hurdles that must be cleared to use the semihorizontal merger model in analyzing the elimination of the network Rep Rule. First, elimination of the Rule must grant the network some control over an affiliate's price, just as a merger would eliminate independence in the pricing of two firms' products. Control could take the form of the network dictating prices for the affiliate's national spot advertising that are above the level that would maximize the affiliate's profits. If a network has not already extracted the full value to the station of the network affiliation (as the networks themselves have argued), then the network would not need to compensate the affiliate. Further, if the network does not need to fully compensate the affiliate for its loss in profits as national spot rates rise higher than the affiliate would choose, the network will have an incentive to raise the price of national spot above the joint profit-maximizing level.

In short, the inability of networks and affiliates to write a perfect or complete contract likely prevents them from reaching the joint profit-maximizing level of prices.[12] In addition, if a network gains the ability to control its affiliates' prices and does not have to fully compensate the affiliate, prices can be set that are even above the joint profit-maximizing monopoly level.[13]

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[11] For an analysis of this "third case," see Werden (1982) at 141-143 and at 158-160 of the Appendix.

[12] See note 1 supra, and BKMW (1984) Chapter 5.

[13] For an analysis of how alternative control and ownership structures affect prices and competition, see Timothy F. Bresnahan and Stephen C. Salop, "Quantifying the Competitive Effects of Production Joint Ventures"" International Journal of Industrial Organization 4

The second hurdle in applying Werden's analysis to elimination of the Rep Rule is that it would seem to require either a network or an affiliate to have unilateral market power. Unilateral market power is a condition in Werden's analysis because he examined the effects of a merger between a single firm in one market and single firm in a second market. However, if the Rep Rule is eliminated, the expectation is that two or more networks will represent many of their affiliates. This would be equivalent to a collection of mergers: rather than one firm in the first market merging with one firm in the second market, several firms in the first (network) market merge with many firms in the second market. The combined effect is then likely to be far greater than the sum of the effects if each were done separately.

B. EFFECTS OF THE NETWORK REP RULE ON THE SUBSTITUTABILITY OF NATIONAL SPOT FOR NETWORK ADVERTISING.

Eliminating the network the Rep Rule could reduce the benefits to advertisers from competition between network and national spot advertising by affecting the nature of national spot advertising -- in particular, by reducing its substitutability for network advertising -- in addition to raising prices for network and national spot advertising. One of the major functions of independent reps is to change the characteristics of the product produced by affiliates and independent stations, transforming capacity that otherwise would be used only by local advertisers into a product that is purchased by regional and national advertisers in lieu of network advertising. That is, independent reps transform a product that would be a weak or limited substitute for network advertising into a product that more closely resembles network advertising, especially at the regional level. The function of reps -- to assemble,

(1986), 155-175.

albeit on an ad hoc basis, a wide audience of viewers attractive to national and regional advertisers -- is very similar to the function carried out in a much more systematic and controlled way by the networks. As independent reps have innovated, with products such as "unwired networks," the characteristics of their product have become increasingly similar to that of network advertising, especially network advertising that is provided on a regional basis and/or bought in the scatter market.

These developments indicate that the substitutability between network and national spot advertising has been increasing steadily over time. Thus, even if it might have been reasonable to conclude in 1980 that network and national spot advertising were not close substitutes, that is no longer the case today. Further, the degree of substitutability between network and spot advertising is itself a product of the Rule -- for example, it seems unlikely that there would be any "unwired networks" today if networks represented affiliates. One clear potential motive of the networks in attempting to replace the independent reps would be to halt or even reverse the transformation of national spot capacity into a product that is increasingly substitutable for network advertising.

Independent reps thus inhibit the exercise of network market power and benefit advertisers in three ways. First, they preserve the affiliates' independence in pricing national spot advertising, providing a close substitute for network advertising at competitive prices to which advertisers could turn should the price of network advertising increase. Second, they change the characteristics and quality of their product to make it easier for advertisers to switch away from network advertising. Finally, competition from new products supplied through independent reps also forces the networks to innovate and adapt their product to compete more effectively with national or regional spot advertising. Thus, eliminating the independent reps and reducing the competition between suppliers of network and spot advertising would affect not only the price but also the quality, and the diversity/range of advertising products available to national and regional advertisers.

III. EMPIRICAL EVIDENCE

The empirical evidence relevant to an analysis of the Rep Rule consists of both econometric studies and from implications that can be derived from the positions taken by the affected parties. The econometric studies examine the effect of concentration and the presence of network owned and operated stations on spot advertising prices. Although these studies do not directly test for the effects of eliminating the Rep Rule,[14] they are worth examining because the earliest studies appear to have significantly affected the recommendations made by the NISS in 1980. To the extent that these studies influenced the NISS, and, in turn, the Commission, it is important to check their validity in light of subsequent work.

The second type of evidence that is useful for testing the likely effects of eliminating the rule are the positions taken by the parties who could either be harmed or helped by the rule. It is our understanding that the networks support lifting the Rep Rule, while the independent reps, the affiliates and many advertisers oppose it. This pattern of support and opposition is consistent with the hypothesis that repeal of the Rule will result in higher

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[14] If spot advertising prices are affected by concentration at the local level or by the presence of O&Os, then the market conditions exist for elimination of the Rule to affect spot advertising prices.

advertising rates and harm to affiliates.

A. THE RELATIONSHIP AMONG COMMISSION RULES THAT AFFECT NETWORK CONTROL OF ADVERTISING.

Three Commission rules directly or indirectly affect the ability of networks to control the supply of spot advertising or the allocation of spot inventory between local and national advertisers: the prohibition against network control of station rates by networks (joint rate making), the restriction on network ownership of local stations, and the prohibition against network representation of affiliates in the national spot market (the Rep Rule).

The first rule prohibits the networks from directly controlling affiliates' national spot rates. Because national spot and network advertising are close substitutes, this rule is akin to the simple prohibition against horizontal price fixing by the antitrust laws. Joint rate making by independent competitors is usually treated as per se illegal because such activity can result in significant harm to competition, whereas banning the activity poses little or no risk that efficiencies or other benefits will be forgone.

This "per se" reasoning, rather than any particular empirical evidence, appears to have guided the NISS in its recommendation to maintain the rule prohibiting networks from directly setting affiliates' advertising rates:

> The prohibition of network control of affiliates' national spot rates appears to serve directly the goal of increasing competition, without denying networks or affiliates any offsetting efficiency gains. Neither localism (aside from the fact that pricing decisions remain in the hands of affiliates) nor diversity seems to be furthered or frustrated by the rule. [BKMW (1984) at 82].

The second rule, which permits networks to own only a limited number of local stations, enables a network to control its O&Os' spot advertising rates as well or better than it could by simply dictating rates to an affiliate. However, the vertical aspects of network station ownership may also result in efficiencies in the production of network advertising that could not be achieved through the affiliate relationship. Thus, even though the horizontal (or semihorizontal) effects of network ownership pose a real threat to advertisers, a "rule of reason" approach, under which the number of stations is set at a level that balances expected efficiency gains against legitimate concerns about concentration, is the correct policy because the vertical effects might lead to significant efficiencies.

The Rep Rule appears to fall between these two rules in that both the potential harm and the potential benefits (or lack thereof) are less clear. On the one hand:

> [As compared to allowing the networks to determine their affiliates' rates for the sale of nonnetwork broadcast time] the practice whereby the networks represented their affiliates in the sale of national advertising could be considered a similar -- if somewhat less effective -- method of reducing price competition between networks and their affiliates. [BKMW (1984) at 82].

On the other hand, the NISS economists argued that there might be efficiencies from allowing networks to represent their affiliates in the sale of spot advertising time -- efficiencies that would not be achievable if the networks were simply allowed to set their affiliates' spot rates.[15] In addition, the NISS considered a third possible reason why the networks might want to represent their affiliates in the sale of spot time:

> [A] network may also desire to represent its affiliates in the national spot market in order to acquire more information about the value of network and nonnetwork programs to its affiliates. In this way, the network may be able to reduce the amount of misleading information it receives from its affiliates, thereby reducing the costs of

[15] The NISS argued that because networks sell advertising time to national advertisers they have established contacts with most advertisers that participate in the national spot market and, of course, possess extensive information about their own network programming. For these reasons, networks may be able to represent their affiliates in the national spot market at costs lower than those of independent firms.

networking and increasing the profits going to the network. [BKMW (1984) at 80].

As this discussion indicates, the strength of the empirical evidence that one would like to have when adopting a policy is related to the possible gains or losses from that policy. In Section II, we indicated that the conditions under which elimination of the Rep Rule could harm the public are far broader or less restrictive than many observers may realize. This means, in turn, that the likelihood of harm is far greater than those observers recognize. Further, as explained below, we believe that the empirical evidence on which the NISS based its recommendation to eliminate the Rep Rule was insufficient to support that recommendation in light of the seriousness of the possible consequences.

B. ECONOMETRIC STUDIES.

The NISS concluded in 1980 that, on balance, the Rep Rule should be eliminated. At the time it reached that judgment, the only evidence available to the NISS concerning the competitive risks from eliminating the Rep Rule was a study it had commissioned by Donald Martin and Gary Fournier [FCC NISS Preliminary Reports, "The Market for Television Advertising," June 1980, hereafter "Martin and Fournier (1980)"] . That study tested two hypothesis that are related, albeit indirectly, to the effects of the Rep Rule: First, does the presence of an O&O station raise spot prices? Second, are prices in spot markets affected by the number of firms in that market or by concentration? As BKMW reported in their 1984 book:

> Some evidence suggests ... that spot prices would not increase if the rule banning network representation of affiliates were repealed. Each network represents all its owned-and-operated stations in the national spot market. Recent analysis of national spot contracts revealed that in those markets containing a network-owned-and-operated station, national advertising spot prices were not significantly different from those in

other markets. [BKMW (1984) at 80.] [16]

Since the original 1980 Martin and Fournier study is apparently the only empirical evidence upon which the NISS relied in recommending against retaining the Rep Rule, it is appropriate to review both the evolution of that study since 1980 and subsequent empirical work that addresses the same issue.

Martin and Fournier argue that the presence of an O&O could affect spot market prices as follows:

> since networks require their own stations to clear relatively more network programs and thus limit competition for national advertisers between themselves and their owned stations, we can expect the time available for spot sales to be lower for O&O stations relative to other stations in the same market. If O&O stations exercise market power, their lower supplies should cause spot prices to be higher in markets that contain such stations. [Martin and Fournier (1980) at 50]

Martin and Fournier find that prices in O&O markets are not higher than prices in markets without O&O stations. Indeed, somewhat startlingly, they find precisely the opposite:

> Viewer exposures sold in markets with O&O stations appear to be less expensive than in other markets . . . In our opinion this result lends support to the conclusion that network owned stations do not exhibit market power since the prices of other stations, competitive with these, are no higher than found in non O&O markets. [Martin and Fournier (1980) at footnote 85].

The effect that O&Os have on spot prices does not provide a direct test of whether allowing networks to represent their affiliates can raise prices. On the one hand, ownership of a station necessarily allows the network to dictate that station's spot advertising rates, whereas

[16] We should note that at this point BKMW reference Fournier and Martin's 1983 article in the Rand Journal, discussed below, although the evidence available to the NISS was the 1980 Martin and Fournier study.

representation gives a network less direct control over a station's spot prices. On the other hand, as discussed above, ownership of a station may also allow efficiencies to be achieved that could offset the effects of greater control over price. However, if the Fournier and Martin finding were correct, it would appear to support the conclusion that elimination of the Rep Rule would not lead to higher spot prices. Specifically, if networks do not raise spot prices in O&O markets, it seems less likely that they would raise them in affiliate markets if the Rule were eliminated. On the basis of the evidence available to it in 1980, therefore, the NISS might reasonably conclude that elimination of the Rep Rule was unlikely to cause significant harm to advertisers. [17]

A revised version of the 1980 NISS study by Martin and Fournier appeared as Gary M. Fournier and Donald M. Martin, "Does Government-Restricted Entry Produce Market Power?: New Evidence from the Market for Television Advertising," The Bell Journal of Economics 14-1 (Spring 1983) 44-56. In their Bell Journal paper, the authors corrected a methodological error in their earlier study and found only that spot prices were not significantly higher (or lower) in markets with at least one O&O than in markets with only affiliates. They also examined again whether horizonal concentration in local markets enables stations to raise prices significantly. They found significant volume discounts by size of purchase that could indicate price discrimination, and hence the presence and exercise of

[17]Even if one were to accept the Fournier and Martin result that concentration in local markets has no effect on national spot rates, a merger (or agreement) between a network and its affiliate could result in high network advertising rates. Note that the primary effect would be on network rates, not on national spot rates. Thus, looking for the effects of O&Os in the national spot market, as Fournier and Martin did, would be to look in the wrong place for the effects of the merger on prices.